CP12/23 – Review of Solvency II: Adapting to the UK insurance market

What are the main takeaways?

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On 29 June 2023, the Prudential Regulation Authority (PRA) published its Consultation Paper 12/23 (CP12/23) covering the first set of proposed reforms to Solvency II in the UK. The CP forms part of the wider ongoing review of the UK's insurance regulatory environment led by the UK Government and in particular HM Treasury (HMT).

The reforms under the Solvency II review are being delivered through a combination of the Financial Services and Markets Bill (FSM Bill), HMT's Statutory Instruments (SIs) and changes to the PRA's rules and policy.

In December 2022, HMT published a policy statement on its implementation plan to deliver a new regulatory framework for financial services regulation in the UK. The legislative changes needed to enable the new regulatory framework are being brought in by the FSM Bill, which gives HMT power to revoke retained European Union (EU) law relating to financial services, including Solvency II.

As part of its plans to legislate directly to implement certain parts of the Solvency II reform package, HMT set out its approach in draft SIs, which brings forward reforms to the Risk Margin and certain aspects of the Matching Adjustment.

Those parts of the reform package not contained in legislation are intended to be implemented through changes to PRA rules and other policy material. The PRA is consulting on its approach to adapting Solvency II for the UK market in two tranches:

- CP12/23, which sets out the majority of the PRA's reform proposals, focusses on simplification, improving flexibility and encouraging entry.
- A second consultation planned for September 2023, which will cover reform proposals for life insurers relating to investment flexibility and the Matching Adjustment.

The proposed reforms to Solvency II included in CP12/23 consist of the following:

- Simplifications and process improvements to the calculation of the Transitional Measure on Technical Provisions (TMTP)
- A new, streamlined set of rules for Internal Models (IMs) where they are used by insurers to calculate their capital requirements
- Greater flexibility for insurance groups in the calculation of group solvency requirements
- The removal of certain requirements for branches of international insurers operating in the UK
- The streamlining and removal of reporting requirements to increase proportionality and reduce complexity
- A new "mobilisation" regime to facilitate entry and expansion for new insurers and to facilitate competition
- An increase in the size of thresholds at which small insurers are required to enter the Solvency II regime

Responses to the consultation are requested by Friday, 1 September 2023, except in the case of a number of administrative amendments to PRA rules, for which the deadline is Monday, 31 July 2023.

With a shortened consultation period, and subject to responses received, the PRA expects to issue the final policy in relation to most of the proposals at around the end of the year.

This paper gives an overview of the key proposed changes in CP12/23 and it is structured as follows:

- Risk Margin
- TMTP
- Internal Models
- Capital add-ons
- Third-Country Branches
- Reporting and disclosures
- Mobilisations
- Other proposed changes

A list of relevant Solvency II legislative texts and rules and PRA regulations which are introduced, amended or deleted as part of the consultation is available in the Appendix. The summary identifies the relevant sections (as listed above) in our paper.

Risk Margin

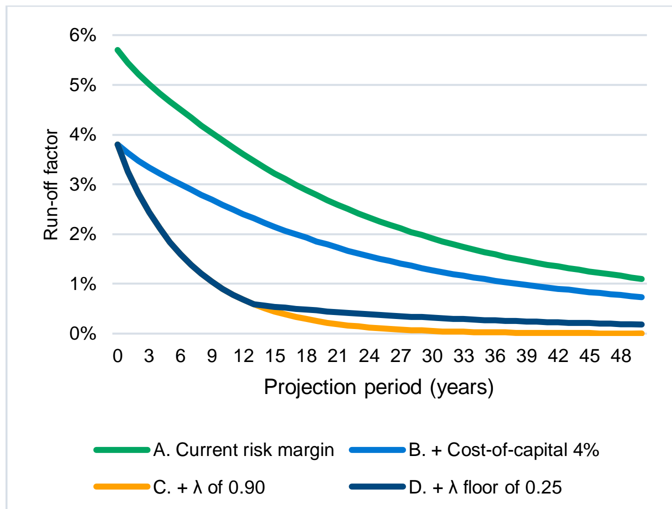
The UK government has previously announced that it would legislate to reduce the Risk Margin (RM) by around 65% for long-term insurance business and 30% for non-life business, and to enable a modified cost-of-capital approach to the RM calculation.

The draft SIs, published on 22 June 2023, set out proposed transitional amendments to the existing onshore Commissions Delegated Regulations, Article 37 Calculation of the RM, as follows:

- The cost-of-capital rate is to be set to 4% (6% currently set out in Article 39 Cost-of-capital rate).
- A parameter λ is included, denoting the risk-tapering factor,[1] set to 0.9 for life insurance and reinsurance obligations and 1.0 for non-life insurance and reinsurance obligations, subject to a floor of 0.25. The minimum of 0.25 bites at projection year 14.

An illustrative four-step analysis of the impact of the proposed changes on "run-off factors" is shown in Figure 1, shown cumulatively from A to D.

FIGURE 1: PROPOSED CHANGES TO THE RISK MARGIN CALCULATION: RUN-OFF FACTORS



Note: "Run-off factors" denote the annual notional RM where the annual Solvency Capital Requirements (SCR) in the RM calculation is set to 1 (e.g., the run-off factor in year 10 is $cost-of-capital \times \frac{\max(\lambda^{10}, 0.25)}{(1+r_{11})^{11}}$). Basic risk-free rates are as at 31 May 2023. In practice, the run-off profile of the RM is expected to be quicker, as SCRs will generally reduce over time as well.

The effect of the proposed changes is to reduce the RM in line with the UK government's previous consultations.

As noted in the draft SIs, the UK government expects that reform to the RM will be in force in legislation by year-end 2023.

The PRA noted in CP12/23 that implementation of the proposed changes to the RM is likely to be a material change to a firm's risk profile, meaning that firms should apply to recalculate their TMTPs, as per the expectations of the PRA's Supervisory Statement 6/16 Maintenance of the "transitional measure on technical provisions" under Solvency II (SS6/16).

TMTP

The primary objectives of the proposed changes to the TMTP are to:

- Simplify aspects of the calculation
- Reduce costs to firms
- Increase the consistency of how the TMTP is calculated
- Place a greater focus on firms' management of the run-off of the TMTP

The TMTP will, by its nature, reduce over time; however, the proposed changes to the RM will also lead to a reduction in the TMTP.

For the avoidance of doubt, we note that, absent any proposed changes to the TMTP, the proposed changes to the RM will generally require firms using the TMTP to apply for a recalculation, as a result of the changes to RM representing a material change to firms' risk profiles in most cases.

In general, the level of TMTP has not reduced as quickly as the linear one-sixteenth per annum set out in the Solvency II rules due to the requirement for firms to regularly recalculate their TMTPs. This has resulted in firms' TMTPs including allowances for changes in assumptions and economic conditions over time. The proposed changes to the RM will overall reduce the level of the TMTP and the new method proposed should simplify the calculation of the TMTP; however, it is difficult to tell at this stage whether it will change the rate of run-off per year of the TMTP.

NEW TMTP METHOD

The PRA proposes to introduce a new default method for calculating the TMTP, which on an ongoing basis is derived solely using figures produced under Solvency II, removing the need to perform any calculations on a Solvency I basis.

The new method requires the current TMTP, excluding the Financial Resources Requirement (FRR) test, to be split into three components:

1. The RM component.
2. The annuity best estimate liability (BEL) component.
3. The non-annuity BEL component.

[1] The risk-tapering factor approach is discussed in the paper A review of the Risk Margin – Solvency II and beyond, Report by the Risk Margin Working Party, the Institute and Faculty of Actuaries, 2019, Section 6.5 Non-independence of risks.

Two factors must then be calculated (Z_A and Z_B), which are the factors required such that just prior to transition:

- The RM component = Z_A x RM portion of the Technical Provisions
- The annuity BEL component = Z_B x annuity BEL portion of the Technical Provisions

On an ongoing basis the TMTP is then calculated as the product of these factors and the RM portion and the annuity BEL portion of the Technical Provisions, respectively, for each reporting period. In other words, the part of the TMTP relating to the RM will be run off in line with the pre-2016 RM, and the part of the TMTP relating to the BEL for annuity business will be run off in line with the pre-2016 annuity BEL.

The non-annuity BEL component of the TMTP will be amortised linearly. This is consistent with the original TMTP approach set out in the Solvency II rules prior to the additional requirements introduced in the UK to recalculate the TMTP at least every other year.

Notwithstanding the approach described above, the new method includes a requirement for firms to annually adjust their TMTPs to ensure they decrease in a consistent manner to reach zero by the end of the transitional period, which could be the most operationally challenging aspect of the proposals.

Firms will no longer have to maintain Solvency II models for the regular recalculations, which will reduce time and costs associated with the TMTP. However, there will be an additional implementation cost for the new method as well as ongoing costs for the annual adjustments to the TMTP.

LEGACY TMTP METHOD

The PRA does acknowledge, however, that the changes proposed to TMTP will, for some firms, under certain economic conditions, produce different results. Therefore, it is proposed that firms which satisfy certain criteria would be able to apply to the PRA to vary their TMTP permissions such that they can continue to calculate the TMTP under the existing approach, with some modifications. When considering applications to utilise this legacy approach, the PRA would consider whether any of the following criteria are met:

- The new method leads to a material financial impact (a change in the coverage ratio by five percentage points or more) in certain economic scenarios
- Maintaining the new method would result in a disproportionately high compliance cost
- The new method significantly disrupts the firm's risk management practices

The PRA will require firms to monitor whether they meet the criteria for maintaining the legacy approach on an annual basis as part of their own risk and solvency assessments (ORSAs), and firms must notify the PRA if the criteria are no longer met. It is expected that most firms which initially use the legacy approach will switch to the new TMTP method prior to the end of the transitional period.

In addition, to simplify the legacy approach, the PRA would no longer permit any changes to the Solvency II Pillar 2 methodology and only allow limited changes to the assumptions. Those firms using the Matching Adjustment would be required to assume in the TMTP calculation that investments in new asset classes would carry the same Solvency II illiquidity premium benefit as the rest of the relevant portfolio.

As per the requirement for the new method, the PRA requires the TMTP to decrease in a consistent manner to reach zero by the end of the transitional period. The approach to achieving this for firms using the legacy method would be bespoke and would require the approval of the PRA.

OTHER CHANGES TO TMTP

In addition to the new method and modifications to the legacy approach, the PRA is proposing the following additional changes:

- Removal of the restriction of the TMTP imposed by the Financial Resource Requirement (FRR), which will reduce the overall calculation burden for firms as well as removing a constraint on the amount of TMTP firms can take credit for.
- An annual requirement for firms to consider whether there are any risks to meeting their solvency risk appetite over the medium term due to the run-off of the TMTP. Many firms will likely already be considering the risks associated with this; however, they will need to ensure that they are documented appropriately, and any necessary actions are taken.
- The TMTP would be recalculated on the final day of each reporting period under both the new and legacy approach. In addition, recalculations would no longer require the PRA's approval. This will reduce the financial and resource burdens of recalculating the TMTP.
- TMTP calculations would be overseen by the Chief Actuary, rather than the firm's Audit Committee. We expect this change is unlikely to result in a significant change in the work carried out, but may streamline certain governance processes.
- For business transfers and 100% reinsurance transactions:
  - Under the new method, firms are required to adjust their TMTPs within two months, subject to no additional TMTP being generated between the disposer of the risk and the acquirer of the risk
  - Under the legacy method, firms will be permitted to update their calculations, subject to no additional TMTP being generated and only following an application to the PRA
- A TMTP can only be applied to Technical Provisions which already have a TMTP permission as at 31 December 2024. Therefore, new applications for TMTP permissions

would only be accepted from firms which are acquiring blocks of business that already benefit from TMTP.

Internal Models

The consultation sets out the PRA's proposals on changes to IM frameworks, aimed at streamlining the requirements that firms (and groups) must meet for permission to use an IM, backed up by safeguards where necessary to retain high modelling standards.

STREAMLINING THE REQUIREMENTS THAT FIRMS (AND GROUPS) MUST MEET FOR PERMISSION TO USE AN IM

The PRA proposes to broaden the circumstances under which it may be possible to grant permission to a firm to use an IM.

Under the current IM approval process, firms are required to comply with all tests and standards (T&S) to receive IM approval. The PRA is required to be satisfied that IMs meet all T&S in full, or otherwise reject the IM for regulatory purposes.

The existing framework does not allow for the possibility of approval of a sound, but not wholly compliant, IM. The PRA considers it preferable to be able to apply a more flexible way for IMs to meet the required standard, by widening the circumstances under which it may be possible to grant permission to a firm to use an IM, as follows:

- Grant a firm permission to use an IM without safeguards, where it has met all relevant standards.
- Grant a firm permission to use an IM that has some residual model limitations (RMLs), so long as safeguards are used to either mitigate the effect of or, in some cases, to correct those limitations, and provided that the noncompliance with the IM requirements and calibration standards stemming from RMLs, as judged by the PRA, are individually, and when considered overall, not significant, in all the circumstances in which the IM is to be used.
- Reject substandard IMs where modelling does not appropriately reflect firms' risk profiles, or where safeguards cannot adequately mitigate or correct noncompliance, or where their use would be inappropriate.

It is worth noting that the additional flexibility in the way in which the PRA proposes to deal with permissions to use an IM is likely to be welcomed by firms, particularly if it can streamline areas such as approvals for new asset categories.

SAFEGUARDS TO SUPPORT MODEL PERMISSIONS

Under the proposed framework, safeguards would be used to allow the PRA to grant permission for a firm to use an IM that had an RML. The consultation proposes two types of safeguards where RMLs exist. The PRA could set:

- An RML capital add-on (RML CAO), which is intended to address an IM residual deviation in the risk profile of a firm from the assumptions underlying the SCR, where the deviation is not considered significant.
- A requirement safeguard, which is a qualitative requirement that would apply to a firm's business practices or IM use. Unlike RML CAOs, requirement safeguards are not expected to impact firms' SCRs.

The consultation notes that the safeguards would be exogenous to the IM (and not part of the IM). The PRA would review all safeguards regularly using an internal model ongoing review (IMOR) framework introduced as part of the consultation.

The IMOR framework will be used as part of the PRA's assessment of the continuing appropriateness of approved IMs, and it will have four strands:

- PRA-driven thematic schedule.
- Analysis of change (AoC) exercise, which is a new requirement introduced as part of the consultation. It will require firms with IMs to complete an annual AoC exercise covering movements in their SCRs and to submit the results of the exercise to the PRA.

  It is also proposed that the AoC replaces the existing requirement to undertake a profit and loss (P&L) attribution.
- Assessment of ongoing IM compliance.
- Monitoring of safeguards.

Capital add-ons

As noted in the previous section, the PRA proposes to introduce an RML CAO in addition to the existing capital add-on framework.

The RML CAO would be an option for firms seeking initial permission for using a full or partial IM, firms applying for a major model change, or firms with existing permissions where the supervisory review process reveals deviations in a firm's risk profile or deficiencies in its models. The framework to determine the size of a deviation in a firm's risk profile and the size of capital add-ons remains broadly unchanged.

However, a change to the methodologies for calculating CAOs is being proposed in exceptional circumstances, for firms with internal model significant risk profile deviations. In these circumstances the PRA would consider setting a CAO calculated as a proportion of the difference between the SCR calculated using a firm's IM and the SCR that would be calculated if either:

- The firm's IM permission was varied (to reduce the scope of the model) so that model components with significant limitations reverted to calculating the SCR using the Standard Formula (SF)
- The firm's IM permission was revoked so that it was required to calculate its entire SCR using the SF.

Firms will continue to be required to disclose any CAOs set by the PRA, and this requirement will also apply to the new RML CAOs.

Third-Country Branches

The consultation paper sets out proposals for insurers operating in the UK as "Third-Country Branches" (TCBs). The key proposals would remove the requirement for TCBs to calculate a branch level SCR and RM as well as the requirement to hold assets in the UK.

The PRA also proposes to remove the ability for TCBs to use transitional measures. Given that, under these proposals branches would no longer routinely be required to calculate a Risk Margin, which is often the key driver of TMTP benefit, then any TMTP benefit would be limited anyway.

The PRA states that its proposed approach to authorising and the ongoing supervision of TCBs is sufficient and the requirement to hold branch capital offers limited additional protection to UK policyholders.

The PRA would require information to form an opinion on the adequacy of the worldwide financial resources and information on the activities that are undertaken by the legal entity, such as how asset portfolios are managed and what reinsurance arrangements are in place. Additionally, a new stand-alone report would also be required to be submitted by TCBs to ensure UK policyholders are given appropriate priority in the event of a winding up.

TCBs may welcome the news of not being compelled to calculate branch capital requirements and hold assets in the UK, but they should also be considering the other changes to the way they may be supervised. It is likely TCBs already operating under Solvency II will have the necessary level of safeguards in place and information available; for example, we are aware that some TCBs already provide this information to the PRA on an ad hoc basis.

TCBs should be aware that the PRA will want to ensure that the legal entities' home jurisdiction capital regime is "broadly equivalent" to the UK, and so firms not falling in that category will likely be subject to more scrutiny.

Reporting and disclosures

The consultation sets out changes to the way firms report and disclose the information required by the PRA. The Regular Supervisory Report (RSR) will no longer be required; the view of the PRA is that other proposed changes set out in the consultation paper would make the RSR less important when it comes to the supervision of insurers.

The PRA aims to set out clearly what is required to be submitted for different types of entities (for example separating out pure reinsurance branches and other TCBs). The intention is to have an overall net reduction in the templates submitted.

Other proposed changes to reporting and disclosures include the below:

- Changes to the methods used to determine the group SCR
- Simplifying reporting to allow for the changes to the calculation of the TMTP
- Replacing templates to improve the way BEL subject to the Volatility Adjustment is reported
- Changing the way IM and partial IM changes are reported
- New template to report on the quantitative impact of the SCR between each financial year-end
- Changing the templates on IM output reporting to include more granular data
- Minor amendments to existing asset reporting templates
- Changes to the Solvency II balance sheet reporting including details of the Matching Adjustment portfolios
- Limiting the requirement to report on best estimate assumptions for life insurance risks
- Minor changes to the reporting requirements on business model analysis for financial guarantee insurers

Mobilisations

The PRA is also proposing an optional mobilisation regime aimed at new insurers entering the market.

The new regime would allow firms to enter a mobilisation period for 12 months before full authorisation is granted but would restrict the activities of that firm. Restrictions include only being able to write new business that covers short-term risks and has a limited net exposure (starting at £50,000), but with the specifics decided by the PRA on a case-by-case basis.

The PRA believes that the mobilisation regime would benefit firms as it gives them confidence that full authorisation would be achieved on completion of the 12-month period, subject to completion of mobilisation activities. Final tasks in setting up a business, such as securing final investments and recruiting personnel, are likely to be easier, with the knowledge that authorisation would be granted at the end of this 12-month period. Firms should note, however, that in the event they are unable to complete all required activities by the end of the 12-month period they would be required to exit the market.

Other proposed changes

A number of other proposed changes have been set out in the consultation:

- **Flexibility in calculating the group SCR**: This is intended to allow insurance groups greater flexibility in the methods available to calculate the group SCR, by temporarily[2] allowing a group to add the results of two or more different calculation approaches when calculating the consolidated

[2] As part of the consultation, the PRA proposes that where it allows the temporary use of more than one calculation approach, the modification would usually be granted for a period of two years while a single group IM (or group-specific parameters) is under development.

group SCR; and to bring in its overseas subgroup's SCR under method 2.

- **Thresholds**: An increase to the current thresholds from when Solvency UK would apply to insurers, which will likely affect approximately nine firms currently reporting under Solvency II.
- **Other:** Currency redenomination from EUR to GBP and administrative amendments to the PRA rulebook as a consequence of the changes.

How Milliman can help

Milliman consultants have extensive experience with Solvency II and its operation in the UK and are well placed to understand the proposals and the implications to insurers.

Milliman can provide tailored assistance and advice on how these proposals can impact firms, navigate the proposed changes and provide modelling assistance if required.

Milliman is also able to assist in formulating responses to the consultation paper, considering the specific need of a firm.

Please get in contact with your usual Milliman consultant if you wish to discuss further.

Appendix: Summary list of proposed changes to relevant Solvency II legislative texts and rules and PRA regulations

Appendices accompanying CP12/23 (with external links)	Risk Margin	TMTP	IMs	CAOs, including RML CAOs	Third-Country Branches	Reporting and disclosures	Mobilisations	Other proposed changes
Draft Insurance and Reinsurance Undertakings (Prudential Requirements) Regulations (UK Government Statutory Instruments)	✓							
PRA Rulebook: Solvency II Reform Instrument 2023		✓	✓	✓	✓	✓	✓	✓
SS17/15 – Solvency II: transitional measures on risk-free interest rates and technical provisions [Amended]		✓						
Permissions for transitional measures on technical provisions and risk-free interest rates		✓						
Solvency II internal models: Permissions and ongoing monitoring			✓					
Expectations for meeting the PRA's internal model requirements for insurers under Solvency II			✓					
SS5/14 – Solvency II: calculation of technical provisions and the use of internal models for general insurers [Amended]			✓					
SS5/15 – Solvency II approvals [Amended]			✓					
SS12/16 – Solvency II: Changes to internal models used by UK insurance firms [Deleted]			✓					
SS17/16 – Solvency II: internal models – assessment, model change and the role of non-executive directors [Amended]			✓			✓		
Table of internal model tests and standards streamlining and how it corresponds to the EIOPA self-assessment template			✓					
Table of examples of the use of proposed safeguards and MLAs			✓					
Solvency II Review: Draft Consequential Reporting and Disclosure templates and LOG file instructions			✓			✓		
Solvency II: Capital add-ons				✓				
SS4/15 – Solvency II: the solvency and minimum capital requirements [Amended]				✓				
SS12/15 – Solvency II: Lloyd's [Amended]				✓				

SS9/15 – Solvency II: Group Supervision [Amended]				✓				
SS44/15 – Solvency II: third-country insurance and pure reinsurance branches [Amended]					✓	✓		
Overview of applicable Branch Guidelines					✓	✓		
Solvency II regulatory reporting waivers						✓		
SS11/16 – Solvency II: External audit of, and responsibilities of the governing body in relation to, the public disclosure requirement [Amended]						✓		
SS40/15 – Solvency II reporting and public disclosure options provided to supervisory authorities [Amended]						✓		
SS7/17 – Solvency II: Data collection of market risk sensitivities [Amended]						✓		
Solvency II draft consequential reporting and disclosure template and LOG file instructions								
Reporting templates [Amended]						✓		
Disclosure templates [Amended]						✓		
SS6/18 – National Specific Templates LOG files [Deleted]						✓		
SS11/15 – Solvency II: Regulatory Reporting and exemptions [Deleted]						✓		

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